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The transition crisis in Bulgaria

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In 1996–97, while making its way through a difficult process of economic and political transformation, Bulgaria was hit by a severe economic crisis. This paper seeks to reveal and analyse the underlying factors and causes of this crisis. It focuses on empirical issues but also highlights some basic causalities and interrelations between economic variables during the crisis as well as the role of economic policy. The economic turmoil in Bulgaria is addressed from three different perspectives: (1) the historic roots of the crisis; (2) the actual evolution of the fiscal, banking and currency crises, and (3) the political economy of the transition in Bulgaria.

Key words: Bulgaria, Economic transformation, Financial crisis, Macroeconomic policy, Coordination failure
JEL classifications: E65, O57, P52

1. Introduction

Several years after the demise of Communism, the process of deep economic and political transformation is well under way in the transition economies of central and eastern Europe and the successor states of the Soviet Union. However, the pace of reform in these countries has been uneven, and the countries have displayed widely diverging performance patterns, often accompanied by turbulence and distress. In 1997–98, a number of transition countries experienced serious economic difficulties related to the fragility of the process of economic transformation: the Albanian economy was shaken by the collapse of large-scale fraudulent pyramid schemes; the Czech Republic—one of the leaders in economic reforms—was hit by an exchange rate crisis; Romania faced serious currency distress and deep recession; finally, the fiscal and currency crash in Russia sent shock waves throughout the whole world. The 1996–97 crisis in Bulgaria was the first in this series and probably the most profound transition crisis so far: a devastating financial turmoil ruined the country's banking system and left its public finances nearly bankrupt. During these two years, the cumulative drop in Bulgarian GDP amounted to more than 18%, and at the beginning of 1997 the country experienced an outbreak of hyperinflation.

The contemporaneous severe financial turmoil in south-east Asia, and the crisis in Russia, attracted considerable public interest in the underlying causes of financial crises in emerging markets. Although both the sources and the nature of the crises in eastern

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Europe and in south-east Asia are in general quite different, in both cases the immaturity and fragility of the market infrastructure and of the institutional environment as well as policy oversight, seem to have played a role in setting the stage for the economic débâcle.

This paper is an attempt to address and analyse some of the factors that led to the emergence and escalation of the crisis in Bulgaria. The paper is focused mostly on the empirical and factual aspects of this transition failure; however, it also seeks to highlight some basic causalities and interrelations between economic variables featuring in the crisis, as well as the role of economic policy in the pre-crisis period. Obviously, a fully comprehensive account of the Bulgarian crisis is beyond the scope of this paper; such a task would require substantial and much more detailed additional research. But, by discussing this stressful episode, the paper mainly aims at highlighting some transition-specific factors that may lead to financial and macroeconomic instability in the course of economic transformation. The policy lessons that can be drawn from the transition crisis in Bulgaria may also be relevant to policy-makers in other emerging markets as well.

The paper is organised as follows. Section 2 discusses the roots of the Bulgarian crisis in view of past legacies and of policies during the initial stage of transition. Section 3 addresses the economic interactions featuring in the crisis, in essence a combination of fiscal, banking and currency crises. Section 4 contains a discussion of the political economy of the Bulgarian crisis. Section 5 concludes.

2. The roots of the crisis

2.1 Legacies of the past

Some of the causes of Bulgaria's transition crisis are rooted deeply in the past and it is necessary to look back at some of these past developments in order better to understand subsequent events. It is a well-known fact that, among the former CMEA-member countries, Bulgaria was the most closely attached to the Soviet economy. Moreover, while in the 1970s and 1980s a number of east-European CMEA-member countries attempted to reorient some of their trade flows to/from other trading partners, the degree of Bulgaria's dependence on trade with the Soviet Union grew continuously during that period. Thus, for example, in the second half of the 1980s, the share of the Soviet Union in Bulgaria's total trade turnover reached more than 50%, a level not recorded in any other European CMEA country.[1] This was coupled with a process of continuous deterioration in overall production efficiency and persistent worsening of Bulgaria's terms-of-trade (Dobrinsky, 1989).

In hindsight, these negative developments were indicating the necessity for a major adjustment of the Bulgarian economy. Regrettably, the Communist authorities were not prepared for a radical policy effort that would have required some painful restructuring measures. Instead, they opted for the less distressing but highly risky strategy of boosting foreign borrowing in an attempt to compensate for the worsening domestic and external

[1] As reported by the official Bulgarian and CMEA statistics of that time. However, it should be borne in mind that past trade data for centrally planned economies are notoriously unreliable. There was no universally accepted methodology of converting 'transferable roubles' (the accounting unit of intra-CMEA trade) and different countries used different approaches which resulted in wild variation in the reported statistics. In 1991, the UN Economic Commission for Europe tried to recalculate past trade statistics using the Hungarian conversion factors which were considered most realistic (EBE, 1991). According to these alternative estimates of the dollar value of CMEA trade at world market prices, the degree of Bulgaria's dependence on trade with the Soviet Union was lower that 50%, but nevertheless still the highest among the CMEA countries.

economic conditions. As a result of this extravagant policy, within five years Bulgarian gross foreign debt more than tripled: from US$2·9 billion in 1984 to US$10·7 billion in 1989.[1] Gross mismanagement and falling export earnings led to the default on the foreign debt in March 1990.

The degree of past dependence on trade with the USSR constituted a major economic handicap during the first years of Bulgaria's transition. By this token, the structure of the Bulgarian economy was probably more similar to that of some of the ex-Soviet republics than to the economies of other CMEA countries, especially those further to the west. Consequently, the shock to the Bulgarian economy resulting from the disintegration of the CMEA economy resembled the shock to these republics from the disintegration of the USSR. As discussed below, the inevitable exposure of Bulgarian producers to international competition unveiled on a massive scale their inherent weaknesses and low viability in market conditions. Had the economy been more open in the past, at least some of these agents could probably have acquired better market skills and greater resilience for operating in the new environment.

2.2 Macroeconomic and institutional arrangements in the first phase of transition

Economic transformation started in Bulgaria in 1991, when the country launched a stabilisation programme similar to the Polish programme of 1990 and to the Czechoslovak one of 1991. It envisaged wide-ranging price liberalisation, opening up of the economy, abolition of central planning and free entry of private economic agents to the market as well as liberalisation of foreign trade. In view of the limited forex reserves and the isolation from international financial markets due to the default, Bulgaria opted for a floating exchange rate regime and money-based stabilisation. A new constitution and a number of legislative acts paved the way for the institutional build-up.

However, the first phase of economic transformation in Bulgaria was characterised by slow reforms and inconsistent economic policies. As discussed in Section 4 below, political instability, lack of public consensus over the course of reforms and stop-and-go policy measures caused a marked deceleration in the pace of transformation in subsequent years and resulted in poor economic performance in this period (Table 1). The deep transitional recession in the initial phase was followed by a weak and fragile recovery in 1994–95, only to set the stage for a new deep plunge in 1996. The fiscal stance was featured by a chronically large budget deficit: monetary policy was *de facto* largely accommodating, allowing for the monetisation of the fiscal deficit. On the whole, Bulgaria did not manage to embark on a steady disinflationary path.

The 1991 stabilisation programme envisaged control over growth of the money supply (as the main nominal anchor) while income control—through regulated wages in the public sector—played a supporting role as a second nominal anchor.[2] While the central bank in principle targeted the level of net domestic assets, the emphasis of monetary control at the beginning was mostly on the credit expansion of commercial banks. Until July 1994, the Bulgarian National Bank (BNB) used credit ceilings to control the credit extended by individual banks directly. In August 1994, the credit ceiling were abolished and the central bank switched to market-based monetary control mainly through open market operations. The BNB also turned to using the reserve requirement more actively

[1] ESE (1993, p. 289).

[2] For a survey of the different approaches to macroeconomic stabilisation and the actual stabilisation programmes in the economies in transition, see Bruno (1992) and Bofinger *et al.* (1997).

Table 1. *Bulgaria: selected macroeconomic indicators (average annual rates of change, %, unless otherwise indicated)*

	1991	1992	1993	1994	1995	1996	1997
Gross domestic product	–11·7	–7·3	–1·5	1·8	2·9	–10·1	–6·9
Gross industrial output	–22·2	–15·9	–10·9	8·5	5·0	–8·3	–10·2
Total employment	–13·0	–8·1	–1·6	0·6	1·3	–0·1	–2·7
Employment in industry	–17·9	–13·2	–8·3	–3·7	–2·2	–1·2	–4·1
Unemployment rate (% of labour force, endperiod)	11·1	15·2	16·4	12·8	11·1	12·5	13·7
Consumer prices (annual average)	338·5	91·3	72·9	96·2	62·2	123·1	1,083·3
Consumer prices (year on year)[a]	473·7	79·5	63·9	122·0	32·9	310·8	578·7
Industrial producer prices	296·5	55·9	26·9	75·0	52·7	138·4	925·9
Average wages and salaries[b]							
Nominal	167·7	102·3	57·8	53·5	53·2	74·7	936·9
Real	–39·0	5·8	–8·7	–21·8	–5·5	–21·7	–12·3
Money supply (M1)[a]	24·2	40·7	27·3	55·5	43·6	119·3	868·0
Money supply (broad money)[a]	118·0	52·5	53·1	78·6	39·6	124·5	359·3
Velocity of M1 (absolute value)	6·46	7·12	7·63	9·60	10·60	12·74	13·54
Velocity of broad money (abs. value)	1·64	1·48	1·54	1·66	1·74	2·14	4·26
Time deposits (domestic currency)[a]	513·8	129·7	86·6	50·0	54·9	27·6	146·8
Budget deficit (–surplus) (% of GDP)	3·6	5·6	10·9	5·5	5·7	11·5	2·5
BNB basic interest rate (annual compound rate, %)	56·5	58·2	58·1	81·8	59·8	245·8	137·1
Average lending interest rate of commercial banks (short-term) (annual compound rate, %)	67·8	74·0	78·3	102·6	79·8	300·2	209·9
Average interest rate of commercial banks on time deposits (annual compound rate, %)	59·2	55·6	52·0	65·1	43·6	146·4	80·8
Gross foreign debt (endperiod, million USD)	12,301	13,858	13,889	11,411	10,229	9,596	9,757
Official foreign exchange reserves (endperiod, million USD)	–	902	655	1,002	1,236	518	2,121
Merchandise exports (million USD)	3,279	3,922	3,721	3,985	5,355	4,890	4,914
Merchandise imports (million USD)	2,647	4,468	4,757	4,185	5,658	5,074	4,886
Trade balance (million USD)	632	–546	–1,036	–199	–303	–184	28
Exchange rate (BGL/USD, period average)	16·7	23·3	27·6	54·2	67·1	177·5	1,682

[a]December over December.
[b]Without private sector.
Source: National Statistical Institute; Bulgarian National Bank; author's calculations.

as a monetary policy tool and decided to reduce (and eventually discontinue) uncollateralised refinancing of commercial banks.

The declared policy on the exchange rate regime was that of a 'managed float': the floating exchange rate was basically market determined and the BNB would intervene as a participant in the market, mostly to smooth the exchange rate dynamics.[1] The daily quoted central exchange rate of the BNB only registered the weighted average price of the daily forex trading by the commercial banks licensed to perform external banking operations. The forex market was dominated by the US dollar with around 90% of the forex transactions denominated in US dollars (BNB, 1996).

Foreign debt service was only resumed in full in 1994 when a debt-restructuring-and-rescheduling agreement was reached with the London Club creditor banks. During the period of the moratorium, the payments due but not paid were actually rolled over, which was a form of involuntary new credits to Bulgaria. In terms of its effect on the exchange rate, the suspension of foreign debt service created a temporary cushion that probably prevented the real exchange rate from adjusting to levels corresponding to the actual balance-of-payments situation and the required level of actual debt service during that period.[2]

The most important policy tool of the central bank was the basic interest rate (the central bank refinancing rate) through which the BNB was implicitly signalling its policy goals. The changes in the basic interest rate had wide-ranging repercussions in the economy. Owing to the high level of dependence of commercial banks on central bank refinancing, the pricing policy of the whole banking sector was literally linked to the basic interest rate (see Figure 1): indeed, almost all interest rate contracts in Bulgaria were made in floating interest, defined in percentage points relative to the basic interest rate.[3]

The BNB had no pre-announced rules for managing the basic interest rate. The decisions on the changes of its level were taken on an *ad hoc* basis reflecting the central bank's perceptions of the current and expected macroeconomic situation. Judging from the actual experience in 1993–96 (Figure 1), the BNB interest-rate policy combined both backward- and forward-looking expectations. However, backward-looking expectations probably prevailed until 1996, with the basic interest rate changing almost in step with the accumulated 12-month CPI inflation. With the escalation of the crisis in 1996, forward-looking expectations started to predominate.

There were some serious gaps in monetary regulation. For example, the monetary authorities mostly concentrated on the regulation of domestic money stock and in fact hardly exercised any control over the broader monetary aggregates, which included the foreign currency circulating in the country. Moreover, before 1996, the commercial banks' open currency positions (including credit exposure in foreign currencies) were not subject to any regulation. One negative implication was the fact that commercial banks could (and, indeed, did) take excessive risks in maintaining large open positions in foreign currencies.

[1] In reality, the central bank did step up on a number of occasions in defence of the currency; however, targeted levels or corridors for the nominal exchange rate had never been pre-announced.

[2] See Fabella (1996), who introduces the notion of 'debt-adjusted real exchange rate' to take into account the burden of the debt service on the level of the equilibrium real exchange rate. *Ceteris paribus*, the larger the debt service, the more the real exchange rate needs to depreciate to equilibrate the balance of payments.

[3] In terms of the implied economic framework, this may be viewed as a system in which there is no independent interest rate (the bond yield) but only the own interest rate on money which is set by the monetary authorities. Theory indicates that equilibrium in such a system may be unstable owing to the fact that the money demand function itself may be highly unstable (Calvo and Végh, 1996).

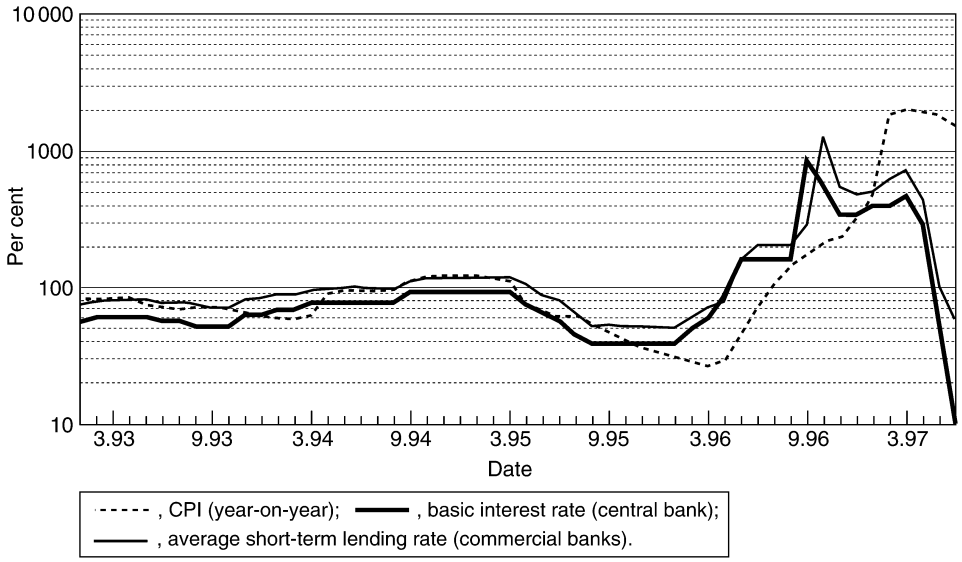

Fig. 1. *Inflation and interest rates. Source: Monthly Bulletin of the Bulgarian National Bank, various issues.*

Another policy loophole was the obvious lack of coordination between monetary and fiscal policy. Indeed, fiscal policy and fiscal management were largely a neglected issue in the macroeconomic policy mix during the first phase of transition in Bulgaria. Consequently, the lack of such coordination, and fiscal mismanagement in general, turned out to be an important source of and channel for macroeconomic instability. As discussed in more detail below, a series of extravagant financial rescue operations resulted in up-front fiscalisation of large quasi-fiscal deficits and in their subsequent monetisation. Thus, although monetary austerity constituted the essence of the declared stabilisation policy in Bulgaria, *de facto* monetary policy turned out to be rather loose and accommodating, and this largely compromised the stabilisation effort.

Some specific features of the macroeconomic environment in Bulgaria in this period should also be pointed out. With all interest rates literally tied to the basic interest rate, the interest-rate policy of the central bank exerted a direct and strong effect on money demand. Given the inherent instabilities of the transitional environment, this considerably increased the responsibility of the authorities in setting a consistent policy mix. However, as discussed below, *de facto* interest-rate policy in Bulgaria in this period was not always coherent—and sometimes even conflicted—with fiscal and exchange rate policy.

Also, one should note the key role that the exchange rate played in equilibrating all markets and in macroeconomic adjustments in that period. Because of a considerable degree of state regulation and the existing inertial mechanisms, prices and wages were not necessarily the first macroeconomic variables to respond to a disturbance, while the flexible exchange rates could immediately absorb the shocks of any macroeconomic disturbance.

2.3 Microeconomic issues

The loss of over 50% of Bulgaria's exports during the first years of transition, mostly in manufacturing industry, meant that a large number of industrial state-owned firms

Table 2. *Aggregated financial accounts of Bulgarian state-owned enterprises*

	1993	1994	1995
Aggregated profit and cash flows as percentage of GDP			
Gross operational income before interest and taxes[a]	–17·5	–6·6	–2·9
Gross profit before taxes[b]	–28·2	–17·7	–10·3
Net profit after taxes[c]	–30·7	–22·2	–13·9
Gross cash flow[d]	–23·0	–17·0	–9·8
Net cash flow[e]	–42·8	–26·7	–20·6
Financing of cash flow losses as percentage of net cash flow			
Budget	9·5	66·6	22·4
of which:			
subsidies	8·0	9·3	7·1
tax and social security arrears	11·5	17·8	14·7
ZUNK operation[f]	–	39·5	0·6
Commercial banks	41·2	13·7	31·7
of which:			
net new lending	15·2	11·3	12·7
loans and interest arrears	26·0	2·4	19·0
Other sources (not identifiable)	39·3	19·6	45·9
Total	100·0	100·0	100·0

[a]Operational revenue (net of subsidies) minus operational expenditure.
[b]Total revenue (net of subsidies) minus total expenditure before profit taxes.
[c]Gross profit (net of subsidies) minus profit taxes.
[d]Net profit plus depreciation.
[e]Gross cash flow minus capital expenditure plus net new long-term loans.
[f]The cash flow effect of the writing off of interest arrears due to the banks under the financial rehabilitation acts.
Source: OECD (1997).

started to experience serious financial problems. This problem was aggravated by the fact that many of these enterprises were equipped with obsolete physical assets and were hardly fit for restructuring. Such firms are practically unviable in market conditions, and this was the diagnosis for a large number of Bulgarian enterprises.[1]

Until 1996, policy-makers in Bulgaria refused to face this problem in its full complexity and gravity. No effort was made until 1996 to impose hard budget constraints on the operation of state-owned firms: the authorities tolerated slack financial discipline and the accumulation of payment arrears. Loss-making firms were allowed to continue operating as going concerns, and this had a contaminating effect on the behaviour of all economic agents. Slack financial discipline became endemic, and the general lack of hard budget constraints discouraged firms from actively pursuing restructuring policies. The delay of privatisation created a power vacuum and a lack of proper governance in state-owned firms after the abolition of central planning. This provoked rent seeking and corrupt practices by company managers and state officials on an unprecedented scale (Avramov and Guenov, 1994).

Economic policy played a perverse role in this process. Instead of enforcing hard budget

[1] Of course, Bulgaria was not unique among the transition economies in experiencing this phenomenon; it affected many enterprises in the whole of eastern Europe. However, the magnitude—and hence the acuteness—of the problem appear to have been much more severe in Bulgaria than in any other former CMEA country.

constraints, inconsistent economic policies in the first phase of transition actually eroded financial discipline in the economy. Probably the most destructive policy measures were the series of unconditional financial bailout operations of state-owned enterprises and banks performed in the period 1991–96 (Dobrinsky, 1994; Dobrinsky *et al.*, 1997B). In fact, none of these policy initiatives of the Bulgarian authorities was designed as a strategic, forward-looking, 'once-and-for-all' act (Begg and Portes, 1992), and they all lacked completely any safeguards against moral hazard. On the contrary, most of these acts were reactive, backward-looking, crisis-management types of *ad hoc* measures aimed at temporarily patching the numerous loopholes in the system. As a result, non-payment of dues became contagious, affecting even financially sound companies which, in principle did not have liquidity problems.[1]

This inconsistent—and rather expensive—policy approach created a vicious circle: while the issue of bad loans remained unresolved as a wave of new bad credits emerged, increasing amounts of public resources were being wastefully poured into the system. The toleration of large-scale, economy-wide, loss-making economic activity resulted in the actual erosion of the net present value of the aggregate productive assets of the country.[2] It is difficult to measure precisely the actual negative economic effect resulting from the continued operation of loss-making firms but, according to some rough estimates, the cumulative gross losses of the state sector alone during the period from 1993 to 1995 amounted to over 50% of the average annual GDP in that period (OECD, 1997).

3. The evolution of the crisis

The Bulgarian crisis can be viewed as a 'triple drain' crisis: it affected at the same time public finances, the banking system and the exchange rate.

3.1 The fiscal crisis

The growing fiscal problems were largely attributable to policy decisions related to the financial rescue of state-owned firms and banks which, as noted above, resulted in the fiscalisation of the quasi-fiscal deficits. The overall outcome was that domestic public debt skyrocketed within a time span of several years (see Figure 2). In the course of time, these highly controversial policy measures backfired in a number of ways.

Not only were the increasing public sector borrowings persistently crowding out business investment, but the snowballing interest payments by the budget started to crowd out all non-interest budget expenditure (Figure 3). As can be seen, although the resumption of the foreign debt service added to the level of foreign interest payments, it was the interest payments on the domestic public debt that were most damaging and harmful: in 1996 they reached almost 17% of GDP. Thus, as a result of the extravagant bailout policy, in the course of several years Bulgaria found itself in a debt trap, with all non-interest budget expenditure becoming hostage to the avalanching domestic debt. In such a situation, the fiscal authorities could not avoid a chronically large budget deficit. The financing of this deficit was controversial, and resulted in its almost complete

[1] The endemic character of slack financial discipline in this period stemming from moral hazard has been confirmed by a number of empirical studies on Bulgarian enterprise performance; see, for example, Avramov and Sgard (1996), Claessens and Peters (1997), Dobrinsky *et al.* (1997A, 1997B).

[2] Loss-making economic activity is not value creating but value subtracting: in the balance sheet of an economic entity, losses carried forward should be subtracted from the assets together with all other liabilities in order to get the proper value of the entity's net assets.

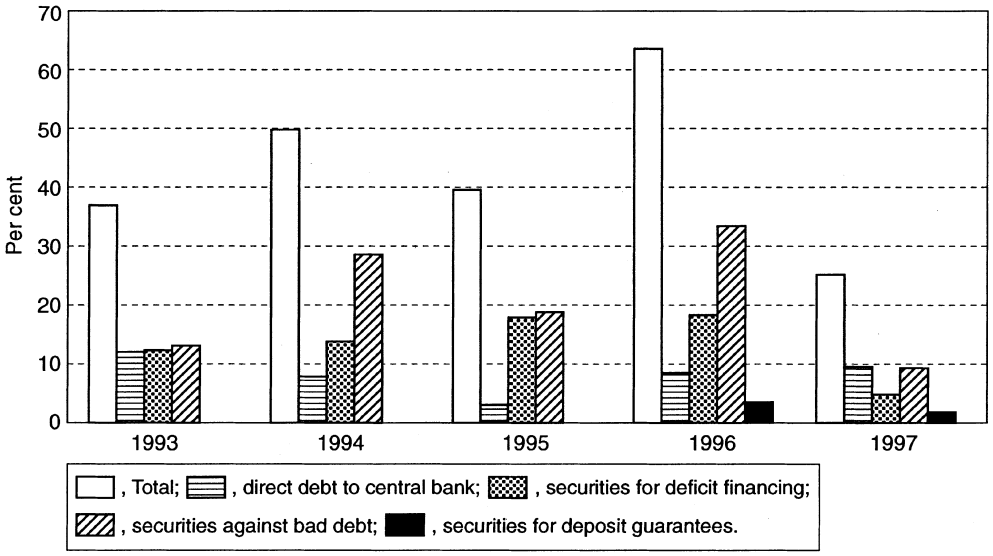

Fig. 2. *Structure of domestic public debt (per cent of GDP) (end of year). Source: Government Debt Management, various issues.*

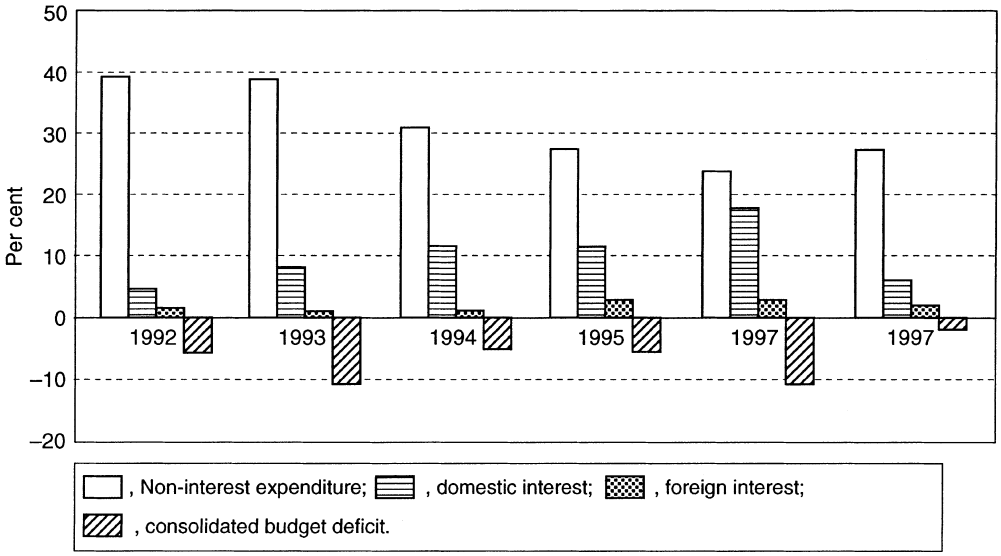

Fig. 3. *Budget expenditure and budget deficit (per cent of GDP). Source: Bulgarian national statistical publications.*

monetisation. The authorities applied a variety of approaches, the end result being the same.

In principle, direct central bank lending to the budget was restricted by law, and the government was supposed to finance the budget deficit primarily through the issue of government bonds. However, with the escalation of the financial crisis in 1996 (which drained the banks of liquid resources, as a result of which the government started to experience problems in the placement of the new issues) pressures for direct borrowing

from the central bank increased substantially (see Figure 2). On several occasions, the central bank also had to intervene as a primary buyer of the bonds used to finance the deficit, with the same macroeconomic impact.

Another channel of monetisation was through Lombard refinancing of commercial banks by the central bank. The banking regulations allowed the banks to use the bonds as collateral for refinancing from the BNB and, if they did so (and this was common practice among commercial banks), this generated new central bank credit. Thus, any net expansion of Lombard credits extended against deficit financing bonds was equivalent to new net lending by the central bank to the budget.

Yet a third channel was the central bank operations with government securities issued against bad debt in the course of the financial rescue operations (Dobrinsky, 1994). Initially, these securities were placed in the portfolios of the commercial banks included in the bailout operations. However, subsequently the banks could use them as collateral for central bank refinancing, with results similar to the above. Moreover, on a number of occasions, the BNB bought such securities from financially troubled banks in exchange for liquid resources, resulting in net money creation.

In addition, it can be noted that the negative fiscal implications of Bulgaria's domestic debt were also abnormally large, owing to the high level of nominal interest rates during the first phase of transition. This implies not only high interest payments on short-term government debt but also accelerated real amortisation of long-term debt, as larger shares of real repayment were made at earlier phases of the debt.[1] Interest-rate policy was the subject of frequent rows between the Ministry of Finance and the BNB and, as discussed later, this sometimes contributed to macroeconomic instability.

To conclude, even on its own, the fiscal crisis in Bulgaria was very grave. It embodied several vicious circles which gave rise to the exponential growth of financial imbalances and increasing macroeconomic instability and, by 1996, the fiscal situation was practically out of control.

3.2 The banking crisis

The banking crisis also escalated as a result of the policy of soft budget constraints, which gave rise to the emergence and snowballing of a new wave of bad loans; at the same time, it was nourished by weak banking supervision and improper banking practices (including corruption), which were tolerated by the authorities.

The confidence of the Bulgarian public in the banking sector was a key factor in the relative stability of the financial system until 1995, whereas the erosion of confidence in 1995–96 played a crucial role in the financial crisis of 1996–97. Owing to the absence of a wider choice of investment opportunities, most of the savings of the population before 1996 were channelled into the banking system, providing the basis for financing the budget deficit and for the expansion of the activities of commercial banks.

Over time, the negative results of protracted financial indiscipline and weak supervision accumulated in the banking system and were reflected in its financial health: by the end of 1995, the standard loans in the Bulgarian banking system amounted to just 25·9% of all loans extended by commercial banks (BNB, 1996). It was thus only a matter of time before the erosion of the banks' assets would show up. In fact, in view of the persistently

[1] This is one example of a vicious circle: inconsistent policies (in particular, fiscal policies) contributed to persistent high inflation; this instigated high nominal interest rates; high nominal interest rates reinforced fiscal problems.

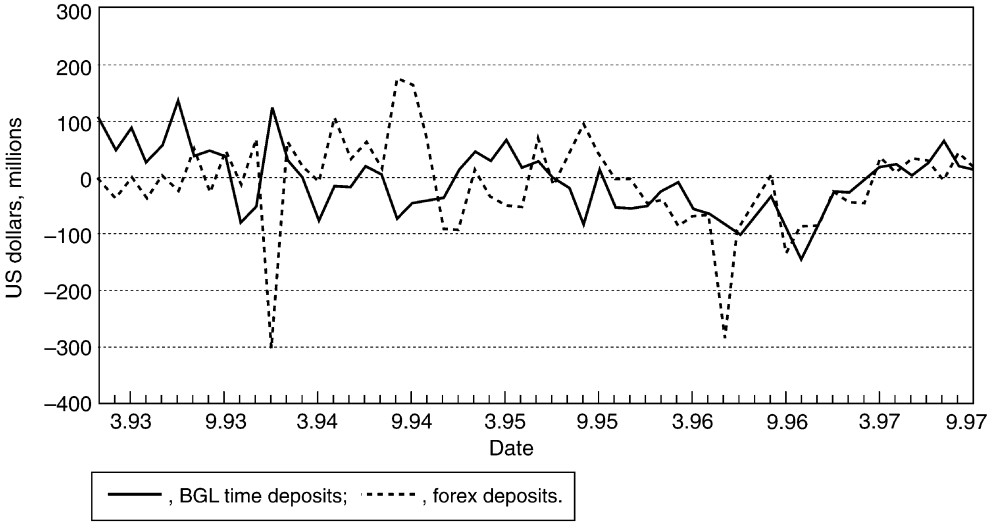

Fig. 4. *Monthly inflows of deposits into the banking system. Source: Monthly Bulletin of the Bulgarian National Bank, various issues; author's calculations.*

deteriorating quality of their loans portfolios, the banks were largely kept afloat by the infusion of new household deposits, acting very similarly to financial pyramids.

Public confidence in financial institutions started to erode in late 1995, when some banks began to experience liquidity problems caused by the unsustainable number of bad loans. The panic, which at first was confined to just those banks that were most affected by liquidity problems, gradually escalated with the subsequent closure of several banks, and towards mid-1996 took the form of a full-scale run on the whole banking system, bringing about massive withdrawals of deposits (Figure 4).

In the period from October 1995 to March 1997 (when the run finally weakened—see Figure 4) the cumulative withdrawals of time deposits denominated in Bulgarian *leva* (BGL) amounted to BGL178 billion (equivalent to US$950 million at the spot exchange rate) and the cumulative withdrawals of forex deposits totalled the equivalent of US$1,120 million.[1] This drain amplified the magnitude of the financial and macroeconomic disturbance and reinforced the liquidity problems of the commercial banks. By the end of 1996, 15 commercial banks (both state-owned and private) were placed in receivership by the central bank, and bankruptcy procedures were initiated against several of them.

Moreover, the simultaneous run on the currency and on the banking system resulted in a massive capital flight. Apart from the forex withdrawals, most of the BGL assets withdrawn from the banks were also converted into foreign currency which, however, remained outside the banks. No data are available on the actual capital transfers abroad, and anecdotal evidence suggests that a large portion of the withdrawn foreign currency remained in the country. However, in terms of the effect on the domestic financial system, almost the whole amount of the deposit withdrawals (with the exception of money spent on consumption or invested elsewhere domestically) can be regarded as capital flight:

[1] To illustrate the magnitude of these numbers, total deposit withdrawals in this period amounted to more than 20% of Bulgarian GDP.

since these assets left the formal domestic monetary system, the weakening effect of the residential capital flight on the banking sector and on the economy as a whole was the same as that of capital flight abroad.

The collapse of the banking system also aggravated the fiscal crisis, and this created another vicious circle. Owing to the liquidity crisis in the banking system, by mid-1996 most new government security issues were under-subscribed and the issues remained partially unsold. In turn, the Ministry of Finance, which also experienced a cash shortage, started to pay the interest due on outstanding securities through newly issued ones, reducing the cash supply to the banks which further worsened their liquidity.

Consequently, the Ministry of Finance was forced to apply more often for cash advances from the central bank, while the BNB often intervened as a first buyer of government securities. Apart from that, the central bank increased (counter to its declared policy goal) the uncollateralised refinancing of the commercial banks. Finally, a special law was passed in December, obliging the central bank to extend a substantial one-time direct credit to the budget. As noted, the effect of these measures was direct monetisation of the fiscal and quasi-fiscal deficits, which reinforced the overall financial crisis and eventually led to the hyperinflationary hike in the first months of 1997.

3.3 The currency crisis

The currency crash (see Figure 5) was rightly considered to be the core of the financial crisis in Bulgaria. This was due to both the psychological impact of the collapse of the national currency and, as noted above, the special role of the exchange rate in the Bulgarian economic framework.

In accordance with the current regulations, exchange-rate policy was assigned to the BNB together with the conduct of monetary policy (the central bank had also full control over the money supply and could set the interest-rate level). In principle, in such a set-up,

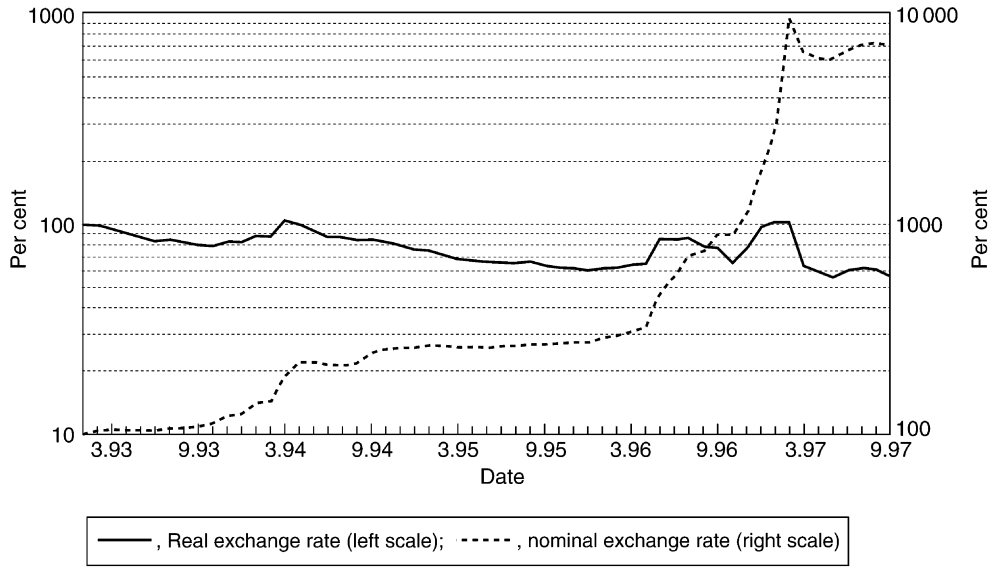

Fig. 5. *Indices of the exchange rate (BGL/US$). Source: Monthly Bulletin of the Bulgarian National Bank, various issues; author's calculations; January 1993=100.*

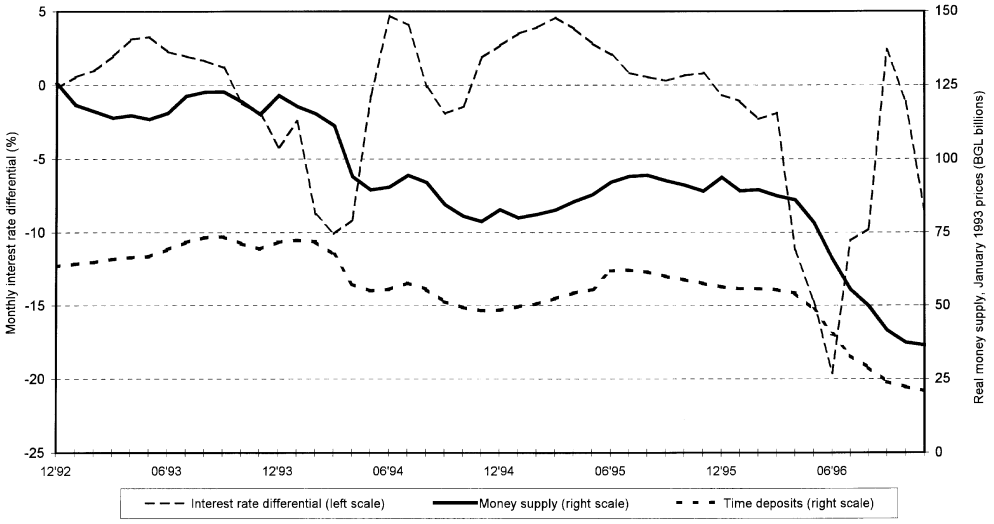

Fig. 6. *Interest rate differential and real money supply. Source: Monthly Bulletin of the Bulgarian National Bank, various issues; author's calculations.*

the exchange rate should be treated as a residual to avoid over-determination of the system.

The preceding discussion suggests that the *de facto* monetary policy of the central bank had been increasingly accommodating, leading to direct monetisation of the fiscal and quasi-fiscal deficits in the economy.[1] Thus the fact that the stock of real domestic money had been declining in recent years (see below) was not a consequence of restrictive monetary policy but of shrinking real money demand, and was therefore a sign of inflationary pressures.[2] No statistics are available to assess the actual monetisation of the fiscal deficit or to compare it with the volume of open market operations since 1994, but a rough estimate indicates that, by 1996, monetary accommodation was almost complete.

The fact that monetary policy did affect money demand strongly is illustrated by the dynamics of different monetary aggregates plotted against the *ex-post* interest-rate differential (Figures 6 and 7). The interest-rate differential is taken as a composite measure of the impact of monetary and exchange rate policy on money demand, as it incorporates the dynamics of both the interest rate and the nominal exchange rate.[3]

Throughout 1992 and most of 1993, the monetary authorities had maintained a policy of 'nominal exchange rate stability', implicitly using the exchange rate as a nominal anchor (Figure 5). The interest rate was kept relatively high, allowing for the build-up of sizeable interest-rate differentials. In the second half of 1993, in two consecutive steps (June and August), the central bank reduced the basic interest rate, presumably responding

[1] Uncollateralised refinancing of loss-making banks burdened with bad loans is equivalent to the direct monetisation of quasi-fiscal deficits.

[2] In terms of policy, this implies a framework in which the authorities use the own interest rate on money as a main policy tool and accommodate the induced money demand.

[3] The interest-rate differential as shown on the figures is calculated as the *ex-post* US dollar return on one-month time deposits denominated in BGL. It is taken as a proxy for the expected deviation from interest-rate parity (which is what actually affects investors' behaviour, say in determining the currency structure of their portfolios).

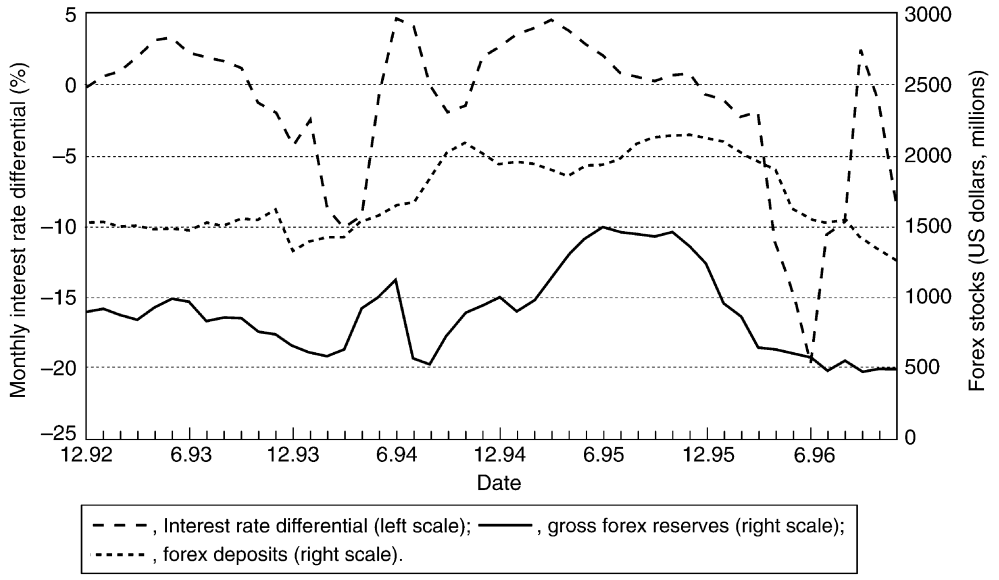

Fig. 7. *Interest rate differential and forex stocks. Source: Monthly Bulletin of the Bulgarian National Bank, various issues; author's calculations.*

to reduced inflation and possibly to pressure from the fiscal authorities. This reduction was sufficient to eliminate the interest-rate differential and thus to destabilise money demand (Figures 6 and 7). At the same time, it was apparently inconsistent with another change in the policy of the monetary authorities.

On the eve of the London Club deal when debt service was to be resumed, pressure started to build on the forex market, and this was felt as early as the autumn of 1993. The central bank was under strain to strengthen forex reserves to meet the up-front payments on the deal, and thus discontinued its interventions on the forex market in support of the BGL. The weakened money demand and the pressure on the exchange rate resulted in a run on the currency which lasted until March 1994. The end of the crisis came in April with the signing of a standby agreement with the IMF providing financial assistance to Bulgaria, in view of the London Club deal.[1]

In fact, what happened in this period reflects both the instability of money demand and the detrimental impact of incoherent policy. The positive interest-rate differential resulted in rising domestic money demand in 1993 (Figure 6). Re-monetisation was in place with switching from foreign into domestic currency assets (Figure 4). Then there were two simultaneous destabilising policy moves (reduction of interest rate and discontinuation of interventions) coupled with a fundamental need for realignment of the real equilibrium exchange rate. The result was a highly destabilised money demand giving rise to a run on the currency and an 'disorderly' adjustment of the real exchange rate (Figure 5).[2]

[1] It was complemented by further assistance from the World Bank and from the EU.

[2] This course of events is in line with a money demand model suggested by Calvo and Végh (1996): in terms of this model, the above policy sequence of changing interest rates can be interpreted as a temporary rise in interest rates that lacks credibility, the likely expected outcome being a subsequent overshooting of inflation, which in fact did take place.

However, the 1994 crisis was confined to the forex market, and died down in the course of time. Two factors played an important role in the arresting the crisis. First, the banking system was still relatively stable (at least, it was perceived as such and enjoyed the confidence of the public) and the currency crisis did not give rise to a run on the banks. Indeed, as seen in Figure 4, it resulted mostly in currency substitution (a reverse switch to forex deposits) but the assets remained in the banking system. And second, the assistance package raised by the international financial institutions temporarily eased the pressure on the forex market.

In 1995–96, events proceeded in a very similar fashion; however, the general economic situation was much more unfavourable.[1] First of all, Bulgaria had started servicing its foreign debt, and the one-off external financial assistance was exhausted. The authorities were facing a dilemma: either to allow a realignment of the exchange rate to its 'debt-adjusted' equilibrium level or to engineer capital inflows to cushion the pressure on the forex market. As it turned out, the authorities could not raise long-term capital to assist the debt servicing: FDI seemed reluctant to come; no bold privatisation steps were undertaken and no attempt to issue new sovereign bonds was made. In these circumstances, they seen to have opted for the highly risky strategy of raising short-term capital inflows as bridge finance to a new IMF and World Bank financial package expected in 1995. The policy instruments were basically the same as in 1992–93 (but presumably with a different policy goal): high interest rate and positive interest-rate differentials which were maintained for almost one year, until mid-1995 (Figures 1, 6 and 7).

In the short term, the results were favourable: higher money demand (Figure 6), substantial capital inflow and increased forex reserves (Figure 7). The accompanying stability of the nominal exchange rate and appreciation of the real exchange rate (Figure 5) were reflected favourably in disinflation and modest growth (Table 1). However, towards the end of 1995, the situation started to change for the worse. During the year, the government failed to reach an agreement with the international financial institutions[2] and thus no new balance-of-payment support could be raised. At the same time, the servicing of the snowballing domestic debt was becoming a major burden on the budget, owing to the high interest rate, and this is where the first breach in the system occurred. Following pressure from the fiscal authorities, the central bank began lowering interest rates in 1995, repeating the same course of destabilising policy measures as two years before; moreover, the reduction of interest rates was much more pronounced (Figure 1). The reaction of the market was also almost identical to that of 1993–94 except that it was much stronger: destabilisation of money demand, demonetisation and capital flight. Up to a point, the central bank defended the domestic currency by interventions in the forex market, but the main outcome was the depletion of reserves (Figure 7).[3]

The state of the banking system was responsible for another important difference in the development of events: whereas the 1994 crisis reflected mostly declining confidence in the domestic currency but continuing confidence in the banking system, the magnitude of the 1996 crisis was amplified substantially by the almost complete loss of public confidence in Bulgarian commercial banks. In the event, the run on the currency in 1996 was

[1] In any case, it is somewhat surprising that the authorities did not learn from the experience of the previous crisis.

[2] A precondition for new financial assistance was the initiation of a major restructuring programme that the Socialist government was reluctant to undertake at that point.

[3] The consequences of this policy-induced destabilising change in money demand within a generally inconsistent macroeconomic policy mix were very much in line with Krugman's (1979) model of exchange-rate crises, the result being a run on the currency and capital flight.

coupled with a simultaneous run on the banking system, resulting in massive capital flight and the failure of 15 commercial banks. As shown by the dynamics of net deposit inflows, both BGL and forex deposits were being withdrawn throughout the whole of 1996 (Figure 4); subsequently, the withdrawn domestic currency was being converted into foreign exchange, causing a drain on the official forex reserves (Figure 7).[1]

The unfolding of the 1996 crisis also unveiled some fundamental inconsistencies in the three main components of macroeconomic policy: monetary, fiscal and exchange rate policy, which created several interacting vicious circles with amplifying destabilising effects. Thus, after provoking the first spark by the reduction of interest rates in 1995, the central bank pursued two mutually exclusive objectives: on the one hand, it was supporting the BGL (by selling foreign exchange and reducing BGL liquidity); on the other hand, it was trying to rescue the failing banks (by injecting liquidity though uncollateralised refinancing). This only fuelled the run on the currency, as the newly injected liquidity simply added to the demand for foreign exchange.[2]

Furthermore, it revealed the lack of coherence between fiscal and monetary policy. On the one hand, the mounting fiscal pressures (which, in turn, were generated by the extravagant bailouts) translated into political pressure on the central bank to lower interest rates which, eventually, it did. However, when the monetary authorities were faced with several emergencies in 1996, fiscal considerations obviously lost priority. At that point, the central bank apparently saw no other option but to revert to its only policy tool—the interest rate. The ultimate fiscal result was exactly the opposite of what the fiscal authorities were aiming for. It was indeed devastating: after the BNB revised the basic interest rate upwards in 1996, the budgetary interest payments associated with the domestic debt jumped to astronomical levels.

Consequently, the central bank itself had to cope with the implications of the rising fiscal deficit which, as already noted, resulted in its full monetisation. In turn, any newly generated liquidity ended up on the forex market, further eroding the value of the BGL. The combined effect of these vicious circles, coupled with political turmoil at the end of 1996 (when the Socialist government resigned), was the outburst of hyperinflation in January 1997.

3.4 In the aftermath

The dramatic deterioration in the economic situation at the turn of 1996 triggered a political crisis and resignation of the ruling Socialist government. Early parliamentary elections were held in April 1997, which brought to power a centrist-right coalition. The new government initiated a drastic change in the course of economic policy, intended to push forward the painful but necessary radical economic reforms: financial stabilisation, rehabilitation of the banking system, fiscal reform, restructuring of the enterprise sector and rapid privatisation. The most important institutional and policy innovation was the introduction of a currency board. According to this arrangement (which became operational in July), the Bulgarian lev was pegged to the German mark for an indefinite period of time, and the BNB discontinued direct lending to the budget, refinancing of commercial banks and open market operations. The most severe restriction affected domestic

[1] These developments were an almost exact confirmation of a prophecy by Dornbusch *et al.* (1995), who argued that, in the case of major misalignments between the current exchange rate and what the market perceives as its true fundamental level, 'policymakers might be misled to yield to real appreciation and financing deficits, but ultimately the country will pay with a collapse'.

[2] In fact, this policy was exactly opposite to the stabilising type of intervention (reduction of liquidity) in a situation of double-drain crisis suggested by Miller (1996).

money supply: the new regulation mandated the monetary authorities always to maintain domestic base money strictly equivalent to the level of foreign reserves.

The transition to the new policy regime was quite smooth, and the period after the hyperinflationary hike of the beginning of 1997 was marked by financial stabilisation and improvement in most macroeconomic fundamentals. Some important macroeconomic indicators, such as the budget deficit, the structure of public debt and public expenditure, showed marked improvement in 1997 (Table 1, Figures 2 and 3), reversing the negative trend that prevailed in previous years. The level of nominal interest rate dropped dramatically (Figure 1) and confidence in the banking system started to return (Figure 4). However, the price of this new stabilisation effort was the loss of monetary sovereignty (implied by the currency board arrangement) for an indefinite period of time.

4. The political economy of the crisis

On the surface, the chronicle of the Bulgarian crisis may well appear simply a story of delayed reform, of badly designed and even worse implemented policies, and this is how it is most often depicted in public debates. Hence, if policy-makers had been cleverer and wiser, things might have worked much better. However, such a view fails to address the issue of the motivation of the policy process, that is, what were the driving forces that led to one or another course of policy action. In addition, it implies exogeneity of policy-making as well as of the inherent political constraints, that is, that any policy decisions on the course of reform might have been made regardless of the outcome of previous policy and of the changing sentiments of the populace.

The recent literature on policy reform has been following a distinctly different line as regards the assumptions on the policy-making environment and process. This literature (see Rodrik, 1993) applies common analytical standards to economic and political behaviour: it assumes that policy agents are rational and forward-looking and that policy-making rules are derived from solving optimisation problems with well-defined objective functions. Following such an approach,[1] some recent studies have been able to come up with plausible explanations for some issues which have for long been a puzzle in political economy, such as, for example: Why do policy-makers opt for apparently sub-optimal—and obviously unsustainable in the longer run—policies while policies that appear optimal are neglected? Why do policy packages which work well in one country not do so in another? Why at a given point in time may a policy package work well in a country when the same package failed in the same country in the past? If a reform package is finally adopted, what can explain the delay?

Thus, it may be helpful to look at the policy aspect of the Bulgarian crisis from the perspective of some recent policy choice models and try to suggest answers to questions such as: What motivated the policy sequencing that led to the crisis? What were the political constraints that policy-makers faced in the first phase of transition? To what extent was the crisis endogenously predetermined and to what extent did it result from inconsistent policy? What were (if any) the alternative policy options and were there policy alternatives that could have prevented the crisis?

[1] This approach is sometimes referred to as 'positive economics of policy reform', a term coined by Rodrik (1993). By applying the positive economics approach to policy reform issues, it has been possible to replace answers which make reference to the ignorance of policy-makers with answers justified by motivated behaviour of policy agents (representing different interest groups) or with answers justified by political constraints (the existence and durability of political support to the reform process).

First of all, it is useful to recall the starting point of the Bulgarian transition. At that time, the policy agenda consisted of two separate sets of issues. On the one hand, there was the transformation agenda that, in principle, was common to all transition economies. However, what was unique was the exceptional magnitude of the restructuring problems in terms of the number of unviable, loss-making enterprises. On the other hand, there was a second set of policy problems, specific to Bulgaria, related to the unsustainable level of the foreign debt and the implied necessity for a major macroeconomic adjustment.

In terms of policy, both the enterprise restructuring and the macroeconomic adjustment problems were hardly marketable to an electoral constituency, as they involved highly painful and unpopular measures. A full-scale enterprise restructuring effort would have inevitably encompassed the liquidation and closure of a very large number of unviable enterprises. It would not be an exaggeration to say that if it had been decided to close all unviable firms, then the magnitude of such a liquidation programme—as measured by the relative share of the affected firms in the economy—would have been unprecedented in scale. And here one may legitimately raise the issue of the political constraints to such an effort. It is well known from western European and US experience that even the restructuring of single sectors—such as coal mining and the steel industry—can take decades to implement; yet despite this gradualism, the political effort has been enormous owing to the resistance of interest groups (mostly the affected workers). The policy option considered above would have required the displacing of a much broader spectrum of the labour force in a much shorter period of time. Even setting aside the issue of economic efficiency, it seems that such an option would then have been politically implausible owing to the magnitude of the political constraints. One can make a similar argument regarding the necessary macroeconomic adjustment, which would have involved a (further) reduction in economic activity.

In fact, one inherent—and irremediable—flaw in both these needed policy reforms was that in the short and even in the medium term (i.e., within the long-term planning horizon of policy-makers) there were no identifiable gainers from them. Of course, in the long run everybody would gain from the stabilisation of the economy, but in the short and medium term—which is what matters for political support—advocating interest groups did not exist and simply could not exist. In terms of the Fernandez and Rodrik (1991) model on the role of uncertainty over the outcome of reform as a political constraint, one could speak not simply of an *ex ante* uncertainty about who will gain from the reform but rather of an *ex ante* certainty that nobody would gain; there might only have been uncertainty about the distribution of losses (some groups would lose much more than others). In fact, this appears as one of the intrinsic political constraints to the implementation of the major restructuring and adjustment effort in Bulgaria at the outset of transition.

To sum up, at the start of transition Bulgaria was facing a major restructuring and adjustment effort; political support for reform was weak (or even absent) owing to the lack of certainty about the gains of reforms; the expected allocation of the costs of the reform was highly uneven. At the same time, the political system was highly polarised and ideological with two main political centres: the Bulgarian Socialist (ex-Communist) Party and the coalition Union of Democratic Forces. As has been shown in the recent literature, both these factors (uneven distribution of costs and a polarised political system) may induce obstacles to the reform process, causing delays in reforms.[1]

[1] Thus, in the so called 'war of attrition' model, Alesina and Drazen (1991) conclude that delays in stabilisations (in the case when instability is due to fiscal imbalances) may arise owing to a political stalemate on the distributional impact of a stabilisation effort. In turn, in their model of delayed reforms, Murphy and Sturzenegger (1996) demonstrate that political polarisation increases the probability of blocking the reforms.

The political motivation of reforms in Bulgaria was further damped down by the short average lifetime of governments, which reduced policy horizons: in the period 1990–96 Bulgaria saw seven consecutive changes of government. In forecasting the duration of the term in office—and thus the planning horizon—a rational, forward-looking policy-maker would take into account (if not extrapolate) the actual experience of his/her predecessors. If the policy-maker is maximising a utility function which depends on the results of policy measures within the duration of the actual term in office, then policies that would eventually yield benefits in the long term, but would obviously incur high costs in the short run, have little chance of being on the policy agenda.

The main conclusion from this brief overview is that, given the economic circumstances, the nature of the necessary reforms, the policy horizons and the inherent political constraints, the actual policy process in Bulgaria in the first phase of transition is compatible with rational behaviour of forward looking policy-makers. This applies also to the fact that the two important economic problems that needed a policy response (and, which, in the end led to the crisis)—microeconomic restructuring and macroeconomic adjustment—were actually left off the policy agenda. Instead, policy-makers opted for the repeated bailout of financially troubled enterprises and banks, and a moratorium on foreign debt. And when the financial problems escalated and there was still no consensus over the sharing of the costs of adjustment, very much in the spirit of the reasoning of Drazen and Grilli (1993), 'monetization and thus inflation were used as the last resort to avoid public bankruptcy' and this led to the financial crisis.

In this regard, one of the most challenging policy-related issues is the extent to which the financial crisis in Bulgaria was endogenously predetermined and to what extent it was provoked by inconsistent policy. However, there probably can be no definite answer on this issue. Owing to the endogeneity of the actual political–economic interactions which lead to a crisis, it is not possible *ex post* either to assert or to deny that the crisis was unavoidable or that it was policy provoked. One could, alternatively, pose the question: were there alternative courses of action in these circumstances that could have prevented the crisis or that would have softened its impact? Again, in view of the endogeneity of the interactions between policy and political support for reforms, such a question will remain mostly in the domain of academic debate. However, what is obvious with the benefit of hindsight is that, regardless of whether the crisis was technically avoidable or not, Bulgarian policy-makers made not the slightest attempt to prevent it, in the sense that, until 1996, no government tried any restructuring effort, even within the available space of actual political constraints. Thus, one can argue that there were missed opportunities in implementing a restructuring effort at an earlier stage of the transition.

In any case, be it endogenously predetermined or exogenously induced by policy, it is the crisis that opened a new window of opportunity for radical policy reform, including the implementation of the long-delayed restructuring and adjustment efforts.[1] Indeed, if we consider the Bulgarian case from this perspective, in a situation of a crisis, the costs incurred by the population, including the interest groups that will be most affected by the reforms, become comparable with the costs of reforms, and political support for the reforms starts to grow. If the costs of the crisis exceed the costs of reform, even those most affected would support the reform measures, and they would be accepted unanimously.

[1] This also has a rational explanation. As shown by Drazen and Grilli (1993), when political support for reforms is weak because it affects large interest groups, it is only a crisis that can stage the conditions for the implementation of delayed necessary but painful reforms. The more severe the crisis, the more likely is it that reforms will finally be started.

I should like to stress specifically that, by trying to provide a rational explanation of the political economy of the crisis, I am not offering a convenient excuse for the numerous obvious policy mistakes that were made during this period. Furthermore, following the above logic, it can be argued that some policy 'mistakes' (in terms of their adverse effect on the economy as a whole or on the majority of society) may indeed reflect a suboptimal decision-making process and/or vested interests. For example, if society and the political spectrum are highly heterogeneous (as was the case in the first phase of transition), heterogeneous interest groups may form a sufficiently strong political coalition and vote unanimously to push through a set of policy decisions each of which benefits only a single minority interest group but is detrimental to the rest of the society. Each interest group in the coalition may be motivated to vote for the set as a whole if the benefit to the group from its 'own' policy offsets the costs incurred by the rest of the policy measures. The result may be a suboptimal policy for the economy as a whole. Thus, the background of many policy 'mistakes' in the first phase of Bulgaria's transition may have been the impact of influential interest groups and, indeed, corruption.[1]

5. Concluding remarks

This attempt to explain the mechanics and the political economy of the Bulgarian crisis is by no means an attempt to advocate crisis. On the contrary, it is an attempt to understand why it happened and whether it could have been avoided. As already mentioned, owing to the endogeneity of political–economic interactions, it is not possible *ex post* either to assert or to deny that the crisis was unavoidable or that it was mostly policy provoked, or that there were feasible, crisis-free transition paths. However, it is possible *ex post* to trace a number of inconsistencies as well as missed opportunities in Bulgarian economic policy during the first phase of transition, which contributed to the escalation of the crisis and to its magnitude.

In this last respect, the Bulgarian crisis is indeed an important lesson to policy-makers in other transition economies. In fact, apart from the foreign debt issue, there is nothing unique in the type of economic problems that led to the crisis. All economies in transition face the problem of restructuring state-owned firms; closing down unviable loss-making state firms is a difficult policy problem in any country in transition; keeping loss-making state firms afloat does imply fiscal costs to all governments in these countries; bad loans have been a major problem in the whole of central and eastern Europe; governments in other countries also engaged in financial bailouts of banks and enterprises; some countries were also burdened with a large foreign debt. One prominent lesson from the Bulgarian experience is that any of these problems, if left unchecked, may give rise to a major financial crisis.

The uniqueness of the Bulgarian case lies mainly in the combination of several serious problems that accelerated the crisis and amplified its magnitude. In fact, it was a combination of a fiscal crisis, a banking crisis and a currency crisis, and each of these three problems was so acute that it might have given birth to a major crisis on its own. The Bulgarian case also provides evidence on the outcomes of a unique policy experience: the actual impact of policy measures and policy decisions in the period preceding the crisis in

[1] For example, it has been recently argued that this type of interest lobbying prevented the introduction of stricter banking supervision regulations which, in turn, enabled bank insiders to siphon off financial resources from the commercial banks.

the highly fragile transition environment. The negative lessons of this experience can also be of interest to policy-makers in other countries.

I name just a few examples. The escalation of the financial crisis is indeed a textbook example of the dangers of moral hazard. The lack of commitment by the authorities to pursuing hard budget constraints and the repeated bailouts led to a complete erosion of financial discipline not only among the financially troubled firms but throughout the whole economy. Thus, inconsistent policy amplified and accelerated the financial crisis; in this case, it was also a disincentive to active restructuring of state-owned firms. Another example is the lack of coordination between monetary and fiscal policy that led to the emergence of vicious circles and widened the macroeconomic disequilibria instead of reducing them. The painful experience with short-term capital flows is not something new but it revealed the degree of vulnerability of a fragile transition environment to external shocks; policy also played a controversial role in this case.

The Bulgarian economic crisis can be regarded as an important warning signal about the fragility of the process of transition from plan to market as well as about some unexpected hurdles and barriers to this process. It also shows that the transformation of a centrally planned economy into a market economy may contain inherent vicious circles because of the inherited structural characteristics of the economy. Under such circumstances, the crisis may act as a catalyst to post-crisis stabilisation reforms.

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